THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

Number 305 **September 1998**

"America's economy is in its eighth year of sustained growth, transcending the German and Japanese miracles. This is no fluke. The unique American brand of entrepreneurial bottom-up capitalism is based on a series of advantages that explain the stunning economic success of the 1990s and provide the basis for extending the winning streak."

"A Second American Century," Mortimer B. Zuckerman, *Foreign Affairs*

"...while the U.S. economy is in a period of robust growth, nothing fundamental has changed. Its long-run growth rate has not accelerated, productivity has not risen, and the structural unemployment rate has fallen by one percentage point at most. Come the next recession, all this triumphalism will seem silly."

"America the Boastful," Paul Krugman, *Foreign Affairs*

The Dominoes are Tumbling

At last, financial pundits and investors are abandoning their silly belief that the Western economies and markets could enjoy several positives of Asia's agony—lower inflation and lower interest rates—yet remain insulated from the negatives of collapsing trade and shattered financial systems.

The contagion from Asia is racing around the world, infecting other far-flung economies. As currencies, stock and bond markets of emerging countries keep falling, one after another, in a vicious downward spiral, the global financial and economic crisis has suddenly begun to spill over to stock and lower-grade bond markets in the United States and Europe. There is a flight from any kind of risk.

The big question to be examined at this juncture is whether this is the beginning of an outright, extended bear market for U.S. and European stocks, or just a major correction that will be followed by a new, strong rebound.

The biggest risk confronting the world economy now is a cumulative decline in U.S. stock prices implicating a cumulative decline in the U.S. economy. The booming stock market has in the last years been vital to the U.S. economy's strong, demand-driven economic growth. Soaring U.S. import demand growth has, in turn, been vital to global economic growth.

Very, very few people are alert to the fact that the U.S. economy is at the bottom of a badly maladjusted bubble economy, and therefore inherently prone to a sudden break. This letter is another major effort to convince you and forewarn you of this looming calamity.

ESSENTIAL BUBBLE INGREDIENTS

The economic and financial woes of Japan and the other Asian countries have arisen from the fact that they all pegged their currency to the U.S. dollar to foster merchandise exports to the huge U.S. market. But by stabilizing their currencies, they destabilized their economies and financial systems. The currency pegs, combined with high domestic interest, gave rise to huge capital inflows which compelled their central banks to expand credit excessively for extended periods. Inordinate domestic money and credit creation, in turn, led all of these countries to a massive, unsustainable misallocation of resources, mainly in the form of overinvestment in commercial property and industrial plant.

Essentially, a prolonged, gross misdirection of resources involves correspondingly gross imbalances in the balance sheets of the private sector. But these remain hidden as long as asset prices continue to increase and feed inflationary demand. Because it gives the associated borrowing and lending binge an apparently sound backing, the resulting asset bubble fuels a simultaneous rapid, unsustainable buildup in debt. All these excesses and imbalances typically go unrecognized until the bursting bubble begins to pound the inflated asset prices, and with them the value of the loan collateral. As the malinvestments of the corporations become the non-performing loans of the banks, the balance sheets both of the lenders (banks) and the borrowers (corporations or private households) are ravaged. Just as financial asset prices and economic activity have risen together, they plummet in lockstep.

Reading the testimonies of Fed chief Alan Greenspan and pertinent Wall Street reports, we are stupefied by the apparent total lack of understanding of the dynamics of asset bubbles. Typically, the soaring consumer debt levels in the United States are glossed over with the reasoning that asset values are rising faster than liabilities, leaving consumer balance sheets in excellent shape after all. Shockingly, even in the face of the dramatic crash of asset prices in Asia, these people have still not grasped that their comforting argument is wrong. Their faith in the vigor of the underlying debt collateral is the very fallacy that has regularly blinded people to the perils of an asset bubble as it develops. Inflating asset prices, which will later collapse, create the chimera of strong balance sheets until the bitter end.

There is still another feature that has regularly fooled policymakers about developing bubble trouble. That's the existence of low rates of consumer and producer price inflation in the face of rapid economic growth. Negligible inflation rates are an absolute requisite for clinching the acquiescence of central banks to the excessive growth in money and credit aggregates that fueled the runup in asset prices. Implicitly, bubble economies unfold completely unimpeded by any monetary restraint. Mr. Greenspan's style perfectly conforms to this mold. As a result, most ironically, the rare periods when booming economies and negligible consumer and producer price inflation have coincided have historically been paradigmatic of a bubble economy, given that inflationary pressures concentrate on the asset markets.

Faced with the pattern of unusually strong economic momentum and falling inflation plus unbridled profit gains since 1995, Wall Street quickly vocalized its claptrap of a "new paradigm" economy. It claimed that such a "miraculous" combination essentially implied a precedent-setting supply-side transformation of the U.S. economy, guaranteeing this growth/inflation/profits miracle for many years to come.

How did this miracle come about? According to Wall Street, through greater efficiency achieved by radical financial and economic deregulation, a flexible labor market, and above all through America's new management culture and skill inspired by the new corporate imperative of maximizing shareholder value. In the end, microeconomic vitality translated into the great economic success of the American economy of the last years.

NEW ERA OR BUBBLE ECONOMY?

Though this sounds rather bombastic, still, doesn't the unusual experience of a booming economy without inflation show that something new and good has been happening to the US economy? The short answer is: No! For one thing, to anyone with a sense of history, the experience of two, three years principally proves nothing for the long run. Critically, the unexpected fall in inflation in recent years has obviously many fathers other than Mr. Greenspan and his bias to notorious monetary looseness.

Paul Krugmann concludes his article in Foreign Affairs: "Certainly there has been no revolutionary improvement in the performance of the United States...None of this is meant to suggest that the U.S. economy

is in any sense on the verge of crisis; our economy does seem fundamentally sound...However, our current sense that we are on top of the world is based on a huge exaggeration of the implications of a few good years here, a few bad years elsewhere."

Obviously, even the highly critical professor does not envisage the possibility that the U.S. economy owes its extraordinary performance to unprecedented financial excesses that have turned it into a highly vulnerable bubble economy. Was the apparent growth real, or merely an asset inflation bubble, after all? On the answer rides the fate of the U.S. economy and its financial markets—and in its wake the fate of the world economy.

The first example in living memory of an episode where a bubble economy was mistaken for the start of a New Era of strong, inflation-free economic growth was, of course, the booming U.S. economy in the late 1920s. After eight years of rapid economic growth and literally zero inflation, the supposed miracle of that decade began to collapse in 1929. The "miracle" was wholly buried in the debris of the Great Depression, which for the United States only ended with the outbreak of World War II—fully ten years later.

WHAT IS INFLATION?

As we have pointed out, negligible inflation is the indispensable prerequisite for the development of a bubble economy. Otherwise, central banks would interfere and tighten. For the very same reason, this phenomenon is badly understood. This is due to the prevailing simplistic, misleading concept of inflation, which is popularly defined today as an increase in the average price level as measured by the consumer and producer price indexes. If there is no consumer or producer price increases, nothing else in the economy or the financial system counts. Indirectly, this logic implies that price stability at the consumer and wholesale level essentially reflects overall stability in the economy and the financial system. This definition of inflation, by the way, comes from America.

The old European economists, primarily of the Austrian school, held a diametrically different view. Above all, they strictly distinguished between inflation's cause and effects. Inflation always has one sole cause, but potentially a variety of effects. That sole cause is a credit expansion in excess of available savings, conventionally called credit inflation, and that's what they primarily focused on. The growth or contraction of credit and money controls interest rates, creates temporary booms, and begets recession and depressions. Credit expansion, in short, is essential in the inflationary process.

Next comes the question of the effects of such a "credit inflation." In varying degrees, it provokes in the economy several malign distortions: first, a misdirection of financial and real resources; second, speculative excesses; and third, overindebtedness. If these three inflationary maladjustments are allowed to go to great excess as it happened in the late 1920s in the United States, in the late 1980s in Japan and in recent years in the other Asian countries, a painful adjustment process will follow, expressing itself in an unavoidable deep, prolonged recession.

As to inflation in consumer and producer prices, the "Austrians" have always downgraded it as just a symptom of underlying monetary inflation—and a very unreliable one at that, because the price performance is all too often perverted by other nonmonetary influences. Pointing to very strong money and credit growth in the 1920s, the Austrian economists saw rampant inflation in the United States. For them, the prevailing price stability had its main cause not in the policy stance of the Fed but in wage increases remaining well below big contemporary productivity gains. Most American economists, in contrast, pointing to zero inflation in the price indexes, proclaimed a New Era of eternal prosperity with strong economic growth and nonexistent inflation.

Turning to the present U.S. case, Mr. Greenspan is wildly lauded as having done a great job of stabilizing the consumer and producer price level. But the soaring money and credit figures since 1995 (see the August letter, page 3) make abundantly clear, the unexpected decline of America's inflation has nothing to do with the extremely loose domestic monetary stance pursued by Greenspan during the last years.

The biggest brake on America's version of inflation in the last few years has not been not U.S. monetary policy, but a variety of extraneous sources. These sources include: the rising dollar, the soaring trade deficit diverting domestic demand abroad, the plunge in oil prices, the general sharp decline in commodity and import prices and, last but not least, the steep fall in the prices for computers and communication gear. The beauty of this high-tech boom with its collapsing prices is that, on the one hand, it substantially adds to real GDP growth, lately around 30 percent, while the plunging prices of this sector substantially subtract, on the other hand, from the inflation rate prevailing in the rest of the economy. All told, the plunging prices of high-tech products have been cutting annually on average 0.6 percentage points off the U.S. price deflator. In the following table, these two effects are sorted out.

THE INFORMATION INDUSTRY IN THE U.S. ECONOMY

	1992	1997	1992-97
	as a percentage of the total		annual % changes
Real output of information industry	0.8	4.0	40.6
Real investment in information equipment	5.6	20.1	38.7
Real net stock of information equipment	1.7	2.6*	24.5
Real GDP, excluding information industry	99.2	96.0	2.2
Real GDP, total	100.0	100.0	2.9
GDP deflator, excluding information industry	-	-	3.0
GDP deflator, total	-	-	2.4

*Net Stock of computers and peripheral equipment relative to net stock of private non-residential equipment.
Sources: U.S. Commerce Department Survey of Current Business; Bank for International Settlements, Basle, 68th Annual Report.

The above figures show clearly that the "miraculous combination" of rapid economic growth and low inflation of recent years in the United States derives heavily from the high-tech sector which, in 1997, accounted for no more than 4 percent of GDP, as against the 30 percent contribution to GDP growth. In terms of current economic growth and changes in inflation rates, this tiny sector, obviously, made all the difference to the U.S. economy's performance compared with the past. Without high tech, U.S. real GDP growth during the five recovery years 1992-97 was just 2.2 percent per annum. That's, by the way, precisely half the annual real GDP growth rate of 4.4 percent during the first five years of the Reagan recovery, 1982-87. Judging by these figures, not a small part of the U.S. economy's glitter has been due to the lack of luster elsewhere.

The fact is that the Fed, shielded by the low inflation rates in the price indexes, allowed a reckless inflation of the financial markets and expansion of the trade gap. Just as in the 1920s in the United States and again in the late 1980s in Japan, apparent price level stability has served as a cloak for protracted, excessive monetary looseness which, over time, has grossly destabilized the whole economy and its financial system.

In a recent hearing of the Senate Banking Committee, Alan Greenspan explained the Fed's inaction with the fear that any U.S. monetary tightening could have "outsized effects" on Asia. It has always been our opinion that this reference to Asia is just a belated excuse. Rather, Mr. Greenspan was in fear that a rate rise in the face

of low headline inflation rates will provoke outraged protests from the business and financial community. If it really were Asia that Mr. Greenspan feared, it would be another ominous parallel to the U.S. bubble of the late 1920s. Supposedly, the Fed's ill-fated monetary easing in the autumn of 1927 was done to support the ailing British economy and currency.

HOW EXCESS LIQUIDITY ENDS IN ILLIQUIDITY

Back to the question: What's next for the U.S. economy? Inflation or deflation? Rebound or deepening recession? It is customary to say that the global financial boom is driven by excess liquidity, and quite a strong body of opinion in the United States expects the existing excess liquidity to feed sooner or later into tangible assets and the general price level for goods and services.

Those who expect this completely misjudge the nature of the process that is going on in the markets. This talk about excess liquidity tends to obscure the fact that in reality there is a flight out of liquidity and into illiquid securities, with the result that cash liquidity is in steady decline relative to the holdings of other assets. What the booming financial markets reflect is not accumulated liquidity but accumulated illiquidity. That is, the economies and the financial systems are becoming progressively illiquid in the sense that debt levels and the holdings of illiquid securities are increasing in excess of money holdings. In the United States, holdings of mutual funds by private households now exceed for the first time ever household bank deposits.

The key point is that each investor can realize his holding of securities only if there is somebody else willing to step in his place and surrender an existing cash balance in exchange for the securities. If on balance there is pressure to sell, the prices of the securities fall. Collectively, selling pressure essentially ends in nothing but wealth and liquidity destruction.

The important point to see is that in this way the excess liquidity of today inherently becomes the general illiquidity of tomorrow. Market liquidity depends entirely on the incessant influx of new money from other investors, maintaining or boosting prevailing asset prices. Once that necessary influx ceases or is interrupted, prices collapse, and the prior super-liquidity transmutes into massive liquidity destruction. Significantly, no major financial bubble has ever before in history spilled over into broad price inflation but always into hard deflation all around. On reflection, in fact, a bubble's very nature—exploding demand for financial assets at the expense of liquidity—literally precludes later inflation. Depending on its size, its bursting presages general price deflation and economic misery.

WHAT CAUSES RECESSION?

For the conventional economist this is a silly question. Recessions arise, when a central bank fails to promptly relax its monetary reins in the face of a slowing economy. If this mistake is avoided, recession is averted. In diametric contrast, the old European economists, again primarily those of the Austrian school, contend that the real cause of a recession or depression must be sought not in the instantaneous economic conditions of the crisis but in the financial and economic maladjustments which accrued during the preceding boom. In this view, the recession, reflecting a necessary painful readjustment after the excesses of the boom is inevitable. The only way to avoid recession or depression is to avoid those prior excesses.

What, in this view, foreordained the Depression of the 1930s, were the protracted national and international credit excesses of the 1920s which, particularly in the United States, had underwritten heavy financial leveraging on Wall Street as well as unsustainable levels of investment and consumption. Remarkably, the associated international credit balloon was the first to burst, weakening economies around the world ahead

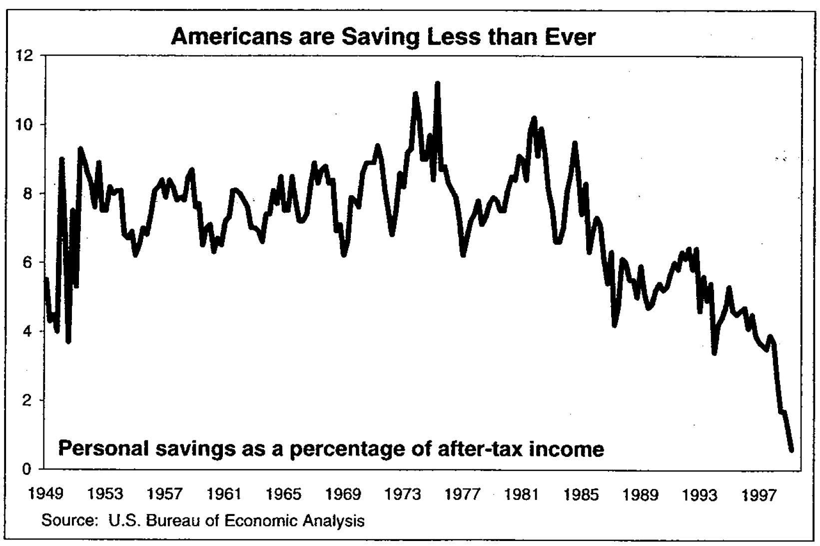
of the U.S. economy. The effect of the Wall Street collapse was, then, to batter the inflated U.S. economy into savage deflation. All attempts to revitalize the U.S. economy with near-zero interest rates, huge injections of bank reserves and massive fiscal deficit spending lamentably miscarried. The parallels with Japan today are really stunning.

American economists, in turn, have put the blame for the Great Depression of the 1930s exclusively on inept monetary policy after the crash, having foolishly allowed a prolonged drastic contraction in the money supply. That the savage economic and financial dislocations that accrued in the wake of the financial asset boom were caused by the boom itself never enters this kind of thinking. Bygone is bygone. Frankly speaking, we find this approach unbelievably simplistic.

Yet precisely this simplistic thinking has again and again blinded policymakers to the hazards of a bubble economy, and it still does. Just consider the gross misjudgment of the crisis first in Japan and again in Southeast Asia. This complete lack of understanding that I've just detailed, is grounded in the simplistic belief that a stable price level attests to the absence of any excesses and imbalances in the economy and the financial markets. In just the same vein, it is blinding Mr. Greenspan and Wall Street to the excesses and imbalances which they have been inflicting on the U.S. economy and its financial markets.

IN SEARCH OF THE CATALYST

Historically, at the end of great booms, stock markets and business activity increase together, and, when the financial asset inflation ends, both slide virtually together. The transition from stock market euphoria to dismay has in every case occurred rather suddenly and, depending on the magnitude of the prior excesses, culminated in an apocalyptic plunge. In our view, the maladjustments which have accumulated in the U.S. economy during the last three years, are frightening. The question is no longer whether there will be a devastating burst but when.



On the surface, the U.S. economy seems to possess immense stamina, driven by buoyant consumer spending that seems well underpinned by heady real income growth, record job growth and sky-high stock prices. But all this is destined to suddenly dissipate, once the stock market stops booming which is bound to happen one day, in our view rather sooner than later. The strong growth in employment and personal income, in particular, is often cited as compelling testimony to the solid robustness of this U.S. economic expansion. Unfortunately, they testify with many other indicators, in reality, to the existence of a bubble economy since both aggregates—employment and income—are largely propelled by the wealth-related spending binge.

A sound stock market reflects economic trends and the profitability of corporations. But a bubble economy turns logic on its head as the booming stock market, through the huge capital gains it delivers, becomes the main propellant of the economy. In Japan, as described in the last letter, the main bubble-related dislocation was the

explosive rise in investment spending. In the United States' case, the most conspicuous dislocation in the economy is the collapse of the personal savings rate, reflecting an out-and-out spending binge. Consumers have, in the last two, three years been drawing heavily on debt and capital gains to finance their spending spree. To a lesser degree, the rocketing stock market has also stimulated business investment in the United States.

Though Americans have never been known for their thrift, the spending spree of the last two years beats everything. For 1997, the Commerce Department has just revised the savings rate down from 3.9 percent to just 2.1 percent of disposable income. Mutual funds' distributions of capital gains had been counted as current income. In the first quarter of 1998, the rate had further plummeted to 0.6 percent, and in June further to 0.2 percent (see chart on page 6). Correspondingly, income growth was grossly overstated. Better than anything else, this plunge of savings highlights the extent to which America's expansion is running on bubble effects.

In America, it is customary to hail the stimulatory effects of the booming stock market on spending as a virtuous cycle. It is supposed to become vicious only if it spills over into general inflation. It is not grasped that these explosive demand effects are the very poison that breeds the following recession or depression, with or without rising inflation rates, simply because such dissaving cannot keep growing.

SELL THE RALLIES

The last rites have been read over this global bull market on several occasions. But each time, frustrating the bears, the rebounds were more powerful than the prior retreat. After all, it became the predominant view that only a substantial rise in the inflation rate and consecutive monetary tightening could break the booming economy and stock market, but that these normal precursors of a bear market were not in sight, and might never arrive. "Buy the dips" has been an article of faith on the Street during the long bull market in equities. It's time to discover the joys of "selling the rallies."

Notably, optimistic commentators have rushed to explain that it requires a much bigger slide of stock prices than has happened to seriously hurt the robust U.S. economy and that therefore the stock market can only rebound. But an economy with a savings rate of virtually zero is per se eminently out of balance. This fact alone betrays all the talk of "new era" and "new paradigm" economy and "growth forever" as complete rubbish. While the U.S. economy, measured by its current momentum, may look very robust, its heavy dependence on the fuel of ever increasing wealth effects makes it in reality an extremely vulnerable bubble economy that is prone to a sudden, sharp downturn.

With the heavily indebted American public far more exposed to equities than at any time in history, there is good reason to believe that the stock market's damage to the economy on the way down will vastly exceed the boost it provided the economy on the way up. The main danger for the U.S. economy doesn't lie in Asia, though that should not be underestimated. It lies at home in the outsized bubble-related domestic imbalances. The Asian crisis has merely precipitated the slowdown rather than caused it.

The decisive and relentless harbinger of the U.S. economy's impending sharp slowdown is the profit deterioration which, for various reasons, can only worsen. It deals the economy two heavy blows in an interactive process. The one blow is on business investment spending, and the other one—through reverse wealth effects from plunging stock prices—is directly on consumer spending. Many seek comfort in the wishful thinking that such effects impact the economy with a great lag. Unfortunately, they tend to hit very fast, and with a vengeance.

IT'S ALL OVER BUT THE ILLUSION

All this leaves us with the pertinent question, how to assess the current recoil in U.S. and European stock prices? Why now? Loose monetary conditions have not changed. In many past letters, we have warned of a sharply worsening trend of U.S. profit growth and that this would finally kill the bull market, even if monetary policy remains loose. In hindsight, we have to admit that the various methods, applied by Wall Street and the corporations, to deceive investors have worked much longer than we thought possible. Nevertheless, we never had a shred of doubt that, sooner or later, the undoing of the prevailing profit illusions would prove the undoing of the frenzied stock market boom. At long last, this is happening. Profit worries are making persistent headlines in market reports. And importantly, there is much worse to come.

Restructuring and shareholder-value blather have been big elements in boosting share prices by bolstering expectations of future gains in productivity and profits, which never happened. It has all been empty talk. True, profits went on a three-year tear, well ahead of what is typical. But what permitted this, in the absence of meaningful productivity improvements, was chiefly a temporary plunge in the interest bills. The much-praised "shareholder value" efficiency is but a mirage. Or let's say, sheer Wall Street propaganda.

Unleashing a consumer borrowing and spending binge is of course one way to boost economic growth. America has achieved this with smashing success. But given the associated literal collapse in personal savings, it is beyond us to understand, how anybody, even someone with only minimal knowledge in economics, can call this an extremely healthy economy. It's just the opposite.

Financial Meltdown

Strains on currencies, stock and credit markets are increasing rapidly around the around the world, hitting primarily the overindebted emerging countries. Since the global debt crisis of 1982 their indebtedness has more than trebled, and since 1990 it has increased from $ 1.2 billion to $ 1.8 billion.

All of a sudden, the words "illiquidity," and "panic" are heard as lenders and investors are confronted with a myriad of crises and few places to hide. In Southeast Asia, stock markets continue to sink fully one year since the crisis first erupted. The losses the in the past month alone reached almost 25% in Malaysia, 20% in Philippines, 15% in Hong Kong and double digit declines in Japan, South Korea, Indonesia, and Thailand. In China, Shanghai B-Shares, which are sold to foreign investors, have sunk 25% in the past month and have year-to-date losses of more than 50%. In Latin America, Mexico, Brazil, Argentina, and Venezuela have 20% losses in the past month. In Eastern Europe, Poland, Hungary, Czech Republic have recent declines of between 10% and 20%. The major European markets have suffered, also, but less dramatically. None of these market situations, however, compares to the debacle that has developed in Russia as stock prices have sunk 40% the past month and more than 70% so far in 1998.

THE RUSSIAN ROUT

Russia now suffers from an absolute collapse in confidence. Not only does the government lack any credibility to deliver on its painfully crafted and widely trumpeted anti-crisis and IMF imposed programs, Russia now must face an increasingly hostile environment. Market participants have almost completely lost faith in the creditworthiness of its companies, government, central bank and fledgling banking system. In a spectacular panic, hedge funds, local banks and other traders are now frantically dumping huge leveraged speculative positions into a market with seemingly no buyers. And with local banks now either unable or

unwilling to honor margin calls and settlement obligations, Russia's inter-bank lending market has broken down. The Russian central bank, trying to manage the crisis, acts as lender of last resort to the major Russian banks but is largely paralyzed as it appears that any liquidity it adds to the system is quickly exchanged for dollars, only adding to the selling pressure on the ruble. The more the bank tries to help, the more it hurts. It appears that each dollar lent to support the Russian system simply provides a bailout for market speculators furiously trying to liquidate positions.

With only $17 billion of rapidly dissipating reserves and more than $30 billion of foreign denominated debt coming due by year end, there are few options. Discounting an inevitable collapse in the ruble, investors now demand yields of more than 200% for short-term government treasuries; recognizing the likelihood of default. Dollar-denominated eurobond yields have skyrocketed to 36% (for comparison, Indonesian dollar-denominated bonds yield less than 15%!). This must be a source of great consternation for investors as it was only in June that J.P. Morgan and Deutsche Bank issued Russian dollar-denominated eurobonds at a yield of 12 3/4%. Initially planning to issue $1.5 billion of new bonds, the sale was increased to $2.5 billion because investor demand was so strong. These dollar-denominated bonds now trade for 30 cents on the dollar, at least that's where they are quoted. With a total 1998 Russian eurobond issuance of more than $11 billion, billions in losses have quickly been dealt to now much more leery investors.

Not surprisingly, a fresh aversion to risk has developed throughout emerging debt markets with ominous portents for the highly indebted Latin American economies. These markets are keenly dependent on new borrowings to finance habitual fiscal and current account deficits; so they are acutely vulnerable to any reduced appetite for risk. With the Mexican peso sinking to new lows and intense pressure imperiling the stability of Brazilian real and Argentina peso, the troubling prognosis is that investors are quickly losing faith in Latin America as well. You can see this effect in the J.P. Morgan index of Latin American debt, which has dropped nearly 10% the past month with the yield spread to treasuries surging to more than 600 basis points. That's the highest spread since the Mexican crisis in 1995.

A LURKING TIME BOMB: DERIVATIVES EXPOSURE

Latin borrowers now confront a severe capital squeeze. An Asian-type market and economic debacle throughout Latin America appears most likely. Certainly, money center banks, hedge funds and other speculators with leveraged positions will be forced to reduce exposure to the region as part of an escalating global deleveraging and liquidity crisis.

Another fault line in today's global crisis runs below Hong Kong and China. With the Hong Kong dollar peg under intense pressure and speculative assault, the Monetary Authority is forced to buy equity index futures and actual stocks while publicly challenging the hedge fund community. This is an unprecendented action for the Monetary Authority. A break in the currency peg now seemingly inevitable, attention is now directed at the Hong Kong banking system. Already, the banks' long-held exemplary reputations are tarnished by a collapsing property market. Property prices in Hong Kong are down by more than 40%, and transaction volume collapsed 84% in July. If, as appears likely, the banks have considerable derivative exposure to the Hong Kong dollar (as was the case with local banks in Thailand, Indonesia and South Korea), the stage might well be set for a similar spectacular meltdown of the Hong Kong banking system.

CHINA BARELY HANGS ON

In China, too, anecdotal data point towards an alarming slowdown. While China has considerable foreign reserves and limited foreign debt, it nonetheless has a hopelessly insolvent banking system, truly massive

unproductive and uncompetitive state industries, and regional bubble economies which will suffer the aftermath of years of malinvestment and speculative excess. The usual pundits focus on the destabilizing impact of a Chinese devaluation. We, however, are most alarmed by the likelihood of widespread bank runs and a collapse of an acutely vulnerable banking system and economy.

JAPAN—THE OLDEST, SICKEST TIGER OF THEM ALL

Throughout Asia, economies have plunged hopelessly in a 1930's style debt and economic collapse—with more on the way. The governor of the Bank of Japan recently acknowledged that the sudden failure of a top bank could pose a serious risk to the financial system. This admission is probably related to the likely failure of Long Term Credit Bank of Japan (LTCB). Importantly, the focus now is on LTCB's off-balance sheet derivative exposure and the issues involved in unwinding these positions, existing across various international markets, with the failure of the bank.

Increasingly, we expect that the focus of financial regulators, central bankers and investors worldwide will be directed towards the growing risk of dislocations in the global market for derivatives. Banks throughout Asia, the Japanese banks in particular, hold huge derivative positions and, as we have discussed in previous letters, it is our view that regional bank insolvencies will inevitably lead to a systemic breakdown for the global derivatives industry. As an aside, in the case of Russian banks, as much $100 billion in currency forward contracts are reported to be at stake.

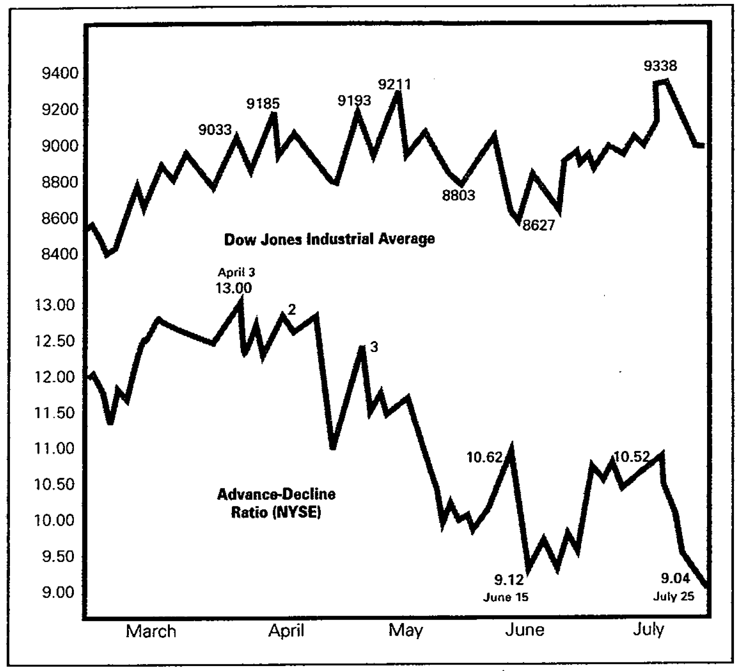
With recent perilous developments, the Topix index of Japanese banking stocks has plunged almost 20% so far this quarter (and fully 75% from its bubble economy highs). Importantly, bank stocks are under intense pressure globally. In the United States, the bank index has slumped nearly 20% since August 1997 highs, with the leading international derivative players—Chase Manhattan, Citicorp, BankersTrust, and BankAmerica—under intense selling pressure. The major Canadian banks, also big derivative players, have also seen their stocks hammered, although factors such as disappointing earnings, the sinking Canadian dollar and a vulnerable debt-laden, commodity-based economy certainly contribute to Canada's problems.

OMINOUS U.S. SIGNS

Looking at the U.S. markets, the crucial question is whether we are seeing the early signs of a loss in faith in the great U.S. bull market. Or, whether this but a normal, and even healthy, correction as claimed by the unflinching bulls. In our view, there is growing evidence that U.S. markets have now entered a bear market and the U.S. financial and economic bubble is being pierced.

As liquidity has abruptly vanished in the junk bond and asset-backed securities markets, credit spreads have widened for corporations, mortgage securities and other lower-grade debt instruments. Only the Treasury is seeing the benefit of lower interest rates. Companies, on the other hand, are forced to cancel offering for lack of demand as junk bond issuance for August is less than $ 3 billion. This compares to more than $ 110 billion in the first seven months of 1998. All the same, the bulls continue to point hopefully to surging Treasury bond prices and a resilient economy as the indefatigable sources of strength for the equity market, conveniently overlooking the fact that the stocks of banks, financial companies and Wall Street firms have plummeted.

Looking at the performance of the vast universe of equities, American stocks have been in a bear market for some time. In fact, the average stock on the New York Stock Exchange is down more than 25% from 52-week highs and, on NASDAQ, the average stock has sunk more than 35%. Such poor performance has not been experienced in the United States since the bear market in 1990. Inarguably, small cap stocks are in the midst of



a painful bear market as the Russell 2000 is now 20% below its April highs and nearly 10% below where it began the year. And, according to Salomon Smith Barney, the average stock with a value of less than $250 million is down 43% from earlier highs. Furthermore, within the S&P500 just 78 stocks provide the entire year-to-date return for this index. To us, this market much resembles the top of the "Nifty Fifty" market of the early seventies that gave way to a devastating and prolonged bear market.

Importantly, sharply weakening profits undermine even the blue chips. According to the *Wall Street Journal,* "At more than 600 companies tracked...net income sagged 1.5% in the second quarter, after a huge one-time gain by MediaOne Group..." According to First Call, total second quarter operating profit growth was 2.7%, the weakest since 1991 (which was a recession year, unlike the current boom year). Yet as 1998 began, consensus analyst estimates called for second-quarter profits to grow 12.9%. Today estimates call for third-quarter earnings to rise just 6.9%, which is certain to be much too optimistic. The bear market for profits has arrived!

WHEN THE CREDIT FALLS, DOWN COMES BABY

The recent poor stock performance and disappointing profits are no surprise to us. However, we are now looking carefully for signs that the expected weak company and market performance, along with global turmoil, is impacting the credit creation mechanism that is at the heart of the U.S. financial and economic bubble. Notably, we find unmistakable evidence of an initial credit contraction as credit spreads widen and increasingly risk-averse investors shun the debt of questionable creditors. In our view, this is potentially a momentous inflection point, foretelling the long inevitable economic downturn and accompanying financial turmoil. In our view, the global economic and financial crisis has arrived at the American doorstep.

As U.S. Treasuries rally in recognition of increasingly global deflationary conditions, other securities languish. Corporate credit spreads have now widened noticeably with investment-grade bond spread increasing 10 basis points and junk-bond spreads widening by 50 basis points or more. Spreads are now the widest since the recession and acute financial stress of 1991. Even with the booming economy, corporate defaults during 1998's first half surged to $8.2 billion, the most for any year since 1991. The default rate for all bonds surged to 2.6%. This compares to 1.23% in 1996. Importantly, junk bond issuance has now plummeted, and many companies are being forced to cancel their offerings. In what looks to provide the potential for a vicious self-reinforcing market sell-off, junk bond fund values are declining, and investors are reacting by withdrawing funds. Interestingly, two new closed-end junk bond funds, Dreyfus High Yields and Managed High Yield Plus, have broken issuance price as investors reassess the risk of such investments. While Wall Street was able to sell almost $100 billion of new junk debt the first half of this year in an unprecedented issuance melee, it now appears this was but the climax in a most extraordinary period of financial excess.

With big losses on foreign stocks and debt securities, we sense that the tide has definitely turned against

leveraged players. Within the U.S. credit markets, huge leverage exists, especially in riskier securities. The flat treasury yield curve has forced leveraged players to move to junk debt, asset-backed securities, and credit spread derivative products in search of better yields. Similar to debt markets globally, recent losses portend a self-reinforcing liquidation and the painful recognition that what had been regarded as strong investor demand for risky securities was but unappreciated leveraged speculation. Faced with significant losses overseas, leveraged players, including hedge funds and the money center banks, will soon move to reduce U.S. exposure. Likely, this has already begun. In conjunction with weak US stock prices, this will likely be the catalyst for cracking the U.S. stock market bubble, and with it U.S. economic growth.

What we are seeing looks all too much like the initial stage of a potentially disastrous loss of faith in the stability of the global financial system.

Plummeting corporate earnings and stock prices, sharply slowing U.S. economic growth, a worse-than-expected trade gap, and a falling dollar could rapidly darken the perception about the health of the U.S. economy.

CONCLUSIONS

It is said that they don't ring a bell at the top of the market. But we hear a peal of bells. Don't let yourself be duped by the low inflation rates into believing that the Western economies are particularly healthy and strong. Overall, the world economy and its financial system are extremely vulnerable. The whole system has been rendered fragile by financial excesses of unprecedented scale that have accumulated in the last years.

Keep this in mind: These excesses are the root cause of the developing global disaster. A prolonged period of excess liquidity fuels a flight from cash into high-yielding riskier investments—and essentially ends in general illiquidity. What we see is the reverse flight: from high-yielding risk into the safety of cash or first-class government bonds. The next big victim are U.S. and European stocks.

As we have stressed before: There are many, too many, resemblances with what happened in the United States and the world in the late 1920s, with one difference: This time, the excesses are far worse.

THE RICHEBÄCHER LETTER

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